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The usual effect of the attempts of government to encourage consumption, is merely to prevent saving; that is, to promote unproductive consumption at the expense of reproductive, and diminish the national wealth by the very means which were intended to increase it. What a country wants to make it richer is never consumption, but production. Where there is the latter, we may be sure there is no want of the former.

— John Stuart Mill, *Essays on Some Unsettled Questions of Political Economy*, 1844

AMERICA'S REALITY — STAGFLATION

Has Hurricane Katrina struck a robust or a fragile and vulnerable U.S. economy? According to the consensus view, it was expanding strongly. Corroboration was seen in particular in recent job gains that were fast enough to lower the unemployment rate to a four-year low of 4.9%.

In our view, the plethora of statistical data was overwhelmingly pointing to slowing economic growth. Consumer spending may have remained surprisingly resilient, but considering its feeble underpinnings in the housing bubble, the time before a marked pullback is, in any case, rather limited. All that is needed to stop the consumer borrowing-and-spending spree in its tracks is a halt to the rise in house prices, implicitly finishing the provision of increasing collateral for higher borrowing.

Reported payroll growth over the first eight months of 2005 has been 1,506,000, averaging 188,000 per month. To those who are impressed, we have to say that this gain is 40% below the average job growth at this stage in past business cycles.

Apparently, most economists have jumped to the happy conclusion that ample construction efforts will soon more than offset the initial hit to economic growth. Devastations are not subtracted from growth, while reconstruction is added to it. Such damage has, therefore, generally tended to boost economic growth.

But this time there is a big difference. Past hurricanes have generally hit resort and retirement areas. Katrina has shut down significant regional economic production and port facilities. The Gulf of Mexico accounts for 30% of U.S. oil production and 23% of natural gas production. Economic activity will be significantly constrained from the supply side. In 2004, Louisiana and Mississippi produced 1.2% and 0.6% of U.S. GDP growth.

To quote John Williams' *Shadow Government Statistics: "The U.S. statistical bureaus face a reporting nightmare in the months ahead. Door-to-door surveying, telephone surveying and company reporting from the storm-damaged area will not be possible for a month or two, perhaps longer. Many businesses no longer exist. That means that employment and unemployment data, in particular, will have to be guesstimated, and those guesses mean that the Bureau of Labor Statistics can come up with any numbers it desires."*

With great interest and attention, we are pursuing the struggle in the U.S. bond market between a large bearish community apparently betting on an impending recession or a period of slow growth triggering the accustomed "Greenspan put" — and a Federal Reserve displaying unprecedented determination to enforce higher long-term rates, so as to slow the housing bubble, increasingly fueled by speculative fervor.

In our view, the bond bulls are right about the economy's weakness. The U.S. recovery is grossly ill-natured, depending fatally on continuous strong support from "asset-driven" consumer spending. Stopping the housing

bubble is sure to stop the mortgage refinancing bubble. To us, this seems like pulling the rug from under the table.

While the bond bulls appear perfectly right in their dire assessment of the economy, we think they are playing a dangerous game. Under apparently tremendous pressure to produce profits, they risk a clash with the Fed. For the Fed people, on the other hand, their credibility is at stake. This might well force them to go further with their rate hikes than they intended.

Further, it has to be realized that today's U.S. bond market is a house of cards. Maintaining long-term interest rates at their present level needs a steady, huge stream of carry trade creating artificial demand for assets. Financial credit soared in the second quarter to $1.124.8 billion at an annual rate, from $648.8 billion in the prior quarter.

If the Fed cracks this trade by inverting the yield curve, this would send long-term rates steeply up. A fire sale of unimaginable proportions could begin, with bond prices crashing. Comparing the credit explosion with the savings implosion and also with a consumer inflation rate now up 3.6% year over year, U.S. interest rates are, in any case, ridiculously low.

Lately, another conundrum has caught our attention: the unprecedented huge and growing wedge between soaring credit growth and dwindling money growth. Our investigations identified two main culprits: the U.S. trade deficit and escalating Ponzi financing of unpaid interest.

AN ENTIRELY DIFFERENT RECOVERY

The best-known fact about the U.S. economy's recession in 2001 is its extraordinary mildness. There were only two quarters with negative growth. For the year as a whole, real GDP increased 0.8%. This compares with an average decline of real GDP by 2% during previous postwar recessions.

An economy's performance during recession, generally lasting one year, is certainly an interesting aspect. Yet far more important are the strength ***and*** pattern of the ensuing recovery over three, four or more years. In essence, it lays the foundation for future longer-term growth. Its composition between consumption, investment, net exports and government spending is, therefore, of utmost importance.

In actual fact, the 2001 recession already had a totally unusual pattern. Prior recessions were triggered by monetary tightening responding to rising inflation rates. Essentially, this put a sharp curb on all credit-financed spending. In practice, these were mainly business investment, both fixed and inventories; residential building; and consumer durables.

Unlike all prior experience, the economic downturn that developed in 2001 clearly had its cause not in tight money and credit. True, during the first half of 2000 the Fed had hiked its federal funds rate in three steps to 6.5%. Yet with a generous provision of bank liquidity, it accommodated a credit expansion of record pace. For the first time ever, the U.S. economy went with roaring money and credit growth into recession — a mild one, though.

Business fixed investment plunged over two years virtually in splendid isolation. Measured in real terms, it fell by 4.2% in 2001 and by 9.2% in 2002, followed by unusually weak growth of 1.3% in 2003. It was by far its worst performance in any postwar business cycle. This investment slump unequivocally broke the boom.

What followed the unique 2001 recession pattern was an equally unique pattern of economic recovery. Still, the unusually fast and aggressive easing had its spectacular immediate and widely trumpeted success in the mildest postwar recession.

Consumer spending never paused, increasing by 2.5% in 2001 and 2.7% in 2002. Its largely credit-financed component of spending on durable consumer goods raced ahead by 4.3% in 2001 and 11.7% in 2002. Equally exceptional was the behavior of residential building. After a slow start, it took off into the famous housing bubble.

Business fixed investment, normally a main driver of recoveries, refused to respond at all. Rather, it accelerated its decline during 2002. And this, in fact, has become and remains America's central structural problem. Though

it has recovered from its lows, it is no higher than in 2000.

As the recovery developed, American publicity kept hammering into people's heads that the U.S. economy is greatly outperforming Japan and Europe. This conveniently diverted attention from the fact that in reality America had its most anemic recovery in the whole postwar period by any measure.

Still, different measures show very different results. By the reported productivity growth, this recovery resembles a "new paradigm" miracle. By the real GDP numbers, the economy appeared to be doing quite well, though much worse than in past cycles. But in terms of employment and wage and salary growth, this recovery has been and remains a disaster.

WHAT OPTIMISM?

From early on, employment and labor income have grossly lagged the top-line GDP numbers. In a *New York Times* article titled "The Summer of Our Discontent," Paul Krugman pinpointed the gross difference between glowing government reports about the economy and the poor reality confronting people in the job market and in their wages and salaries:

> ***American families do not care about GDP. They care about whether jobs are available, how much those jobs pay and how their pay compares with the cost of living… The bottom line, then, is that most Americans have good reason to feel unhappy about the economy, whatever Washington's favorite statistics may say. This is an economic expansion that has not trickled down.***

But apparently, most Americans do not feel that way at all. Abandoning any saving from current income and piling up unprecedented indebtedness against the backdrop of extremely poor employment and income growth requires either total economic stupidity or a big dose of optimism for the future. Assuming the latter, we think of the worried French and Germans simultaneously putting one-tenth of their current income into savings.

During the last six months to July 2005, private households in the United States jacked up their real expenditures at an annual rate of 4.8%, while their real disposable income grew just 2% at annual rate. More or less, this has been going on for three or four years.

We have been wondering for a long time where Americans derive their indefatigable optimism from in the face of unusually poor employment and income growth. They certainly have a general disposition to always look at the favorable side of events, while Europeans have the opposite disposition. Yet we think that there is something else to this notorious American optimism in defiance of extremely negative economic facts.

We see an enormous difference in the behavior of policymakers and economists in the United States and in Europe. In the United States, everybody seems to regard it as his duty to animate spending by spreading optimism about the economy and its future, while belittling or flatly discarding the existence of any economic problem, however obvious and serious. Just compare the pronouncements by cheerleader Fed Chairman Alan Greenspan with those of the reticent Jean-Claude Trichet, president of the European Central Bank.

TWO DIFFERENT MEASURES OF PERFORMANCE

In actual fact, the U.S. economy shows two radically different kinds of data. On the one hand, there are the good-looking top-line statistics, mainly GDP and productivity growth. On the other hand, there are very bad-looking data revealing extremely poor employment and labor income growth since 2000.

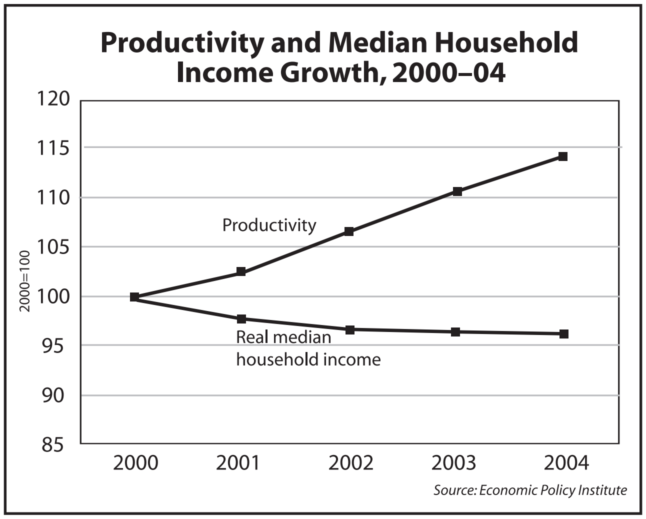
A particular bone of contention for us is the virtual cult of the reported stellar productivity numbers. For American economists, it is the most important proxy for a rising living standard. Indeed, this has always been true for all countries. Wages and productivity growth have moved in close step forever.

But the extraordinary fact about the U.S. economy's present recovery is that reported record productivity growth went together with record-low wage growth. During the boom years between 1995–2000, labor productivity had grown by "only" 2.5% per year, close to one percentage point faster than in the prior 20 years. During this unusually slow recovery, however, it raced ahead at a record pace of 3.5% per year.

There can be no question that this reported surge in productivity growth has crucially contributed to creating the perception of the U.S. economy's superior performance. Amazingly, American economists generally take all statistics as if coming from George Orwell's Ministry of Truth, even though they are grotesquely out of line with correlated data.

It ought to have alerted American economists long ago that the reported stellar productivity numbers are absurdly out of whack with the reported inflation rate and the poor wage numbers. A rise in labor productivity by 15% over four years, as reported, implicitly means that labor costs per unit of output have declined by this rate. If true, this would imply an inflation rate close to zero. Instead, it is above 3%.

No less a mockery of the fabulous productivity numbers are the miserable income numbers. See the chart.



Assessing this chart, it has to be taken into account that the U.S. consumer price index, presently 3.6% year over year, grossly understates the inflation rate, implying a corresponding overstatement of the reported real GDP and productivity growth. Considering further the major structural shift in the U.S. economy during previous years, in particular the ravage of the productive manufacturing sector, productivity growth should by reason be at its lowest ever.

Looking at the U.S. economy from the macro perspective, two observations are categorical for us. One is that saving and investment are two key conditions for present and future productivity and prosperity. And the other is that in an economy, actually the U.S. economy, in which these two macroeconomic fundamentals are at record lows, there cannot be much productivity and prosperity. Taking the asset inflations away, there is, in fact, general impoverishment.

THE FAMOUS U.S. JOB MACHINE HAS BROKEN DOWN

With this consideration in mind, our focus is especially on changes in employment and wage rates as the main income source of the working population.

Past postwar recoveries in the United States distinguished themselves with outbursts of employment growth. The first exception to this rule was the recovery from the 1991 recession, in hindsight called the "jobless recovery." But what has been happening to jobs since 2001 is incomparably worse. By the reckoning of Morgan Stanley economists, private nonfarm payrolls today are more than 10 million below the cyclical profile of the past five economic recoveries.

According to a briefing paper by the president's Council of Economic Advisers in February 2003, employment would rise by 4.1 million new jobs from mid-2003 through the end of 2004 without the tax cuts and 5.5 million with the tax cuts.

Recall those net birth/death jobs do not accrue from the regular payroll surveys but from a statistical model — in other words, an estimate — bearing this name. It is based on the assumption that in every economic recovery a lot of people start their own businesses, involving extensive job creation that the regular job survey does not capture in time.

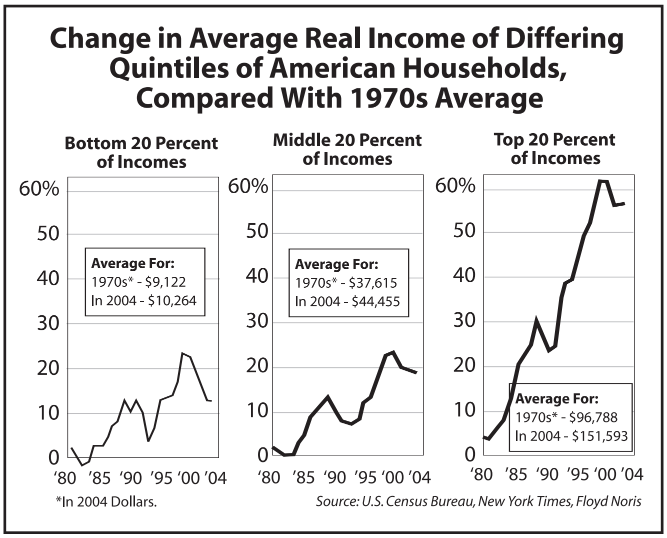
Plainly, job creation as recorded by the survey has slumped. But that does not prevent the Bureau of Labor Statistics from "guesstimating" record job creation by new firms. To us, this is so absurd that it definitely smacks of deliberate deception.

The currently applied annual net birth/death factor of more than 800,000 per year has been derived from the experience in past recoveries. In July, by the way, the reported 169,000 new jobs included 132,000 jobs from

the net birth/death model.

Actually, the BLS explicitly admits in its commentary on this model that it is essentially unreliable *"at economic turning points or changes in trend."* When is accuracy more important than at these junctures?

The important point we want to convey is the extraordinary weakness of the present U.S. recovery in employment and wage-income growth. In its just-published report on income and poverty in the United States, the U.S. Census Bureau attests that adjusted for inflation, the mean incomes of all classes in the United States — rich, middle class and poor — were in real terms by 2004 below their levels in 1999. For the 40% of the middle class, earnings were down 3.8% and up just 18.2% over the 34 years since 1970.



Now try to reconcile the following figures from the same period 1999–2004: productivity, +18.6%; real GDP, +15.1%; average gross real hourly earnings, +0.25%.

Very poor employment growth is clearly the main cause of the exorbitantly poor growth of wage and salary income. But there is a second negative force at work: the drastic shift in employment between different sectors. The outstanding sole job loser since 2000, by about 3 million jobs, has been high-paying manufacturing. The main gainers, on the other hand, have been low-paying education, health services, leisure and hospitality jobs. The obvious single main source of job creation has been the housing bubble through construction and real estate jobs.

Lately, a third factor is depressing real wage growth. Throughout 2001–02, inflation-adjusted wages had still been slightly positive. But since then, the persistent job market weakness has been taking its toll on further wage increases. In 2004, nominal wages rose 2.1%, their lowest rate in the whole postwar period, after 2.7% the year before.

As the inflation rate of consumer prices simultaneously accelerated from 2.3% to 2.7%, real wage rates are effectively falling. For 2005, the year-over-year inflation rate is already at 3.6%.

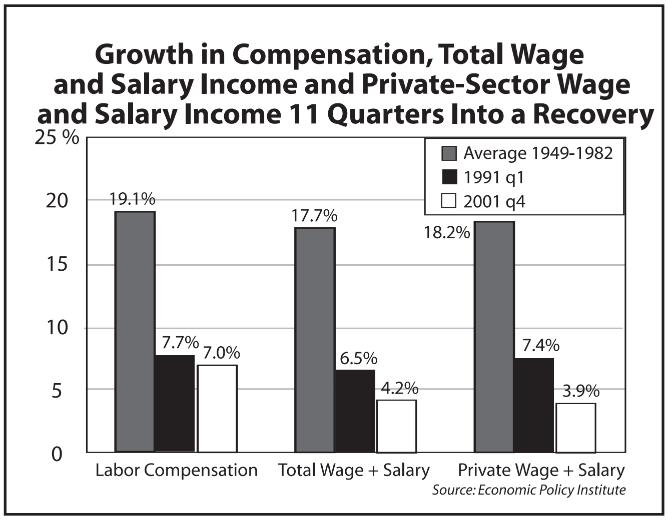
Average inflation-adjusted labor income per person is, according to other statistics, presently virtually level with that in 2000. The BLS publishes two corresponding series. One is "Average of Gross Hourly Earnings in the Private Nonagricultural Sector" and the other is "Average of Gross Weekly Earnings," both calculated in 1982 dollars. What happened to the two?

Average wage rates over the 4 1/2 years from 2000 to June 2005 have risen from $8.03 to $8.21. Average weekly earnings increased over the same period from $275.62 to $276.59. To recall, these are inflation-adjusted numbers.

What they show is literal income stagflation over more than four years now for America's working population, counting now close to 150 million workers and employees with their families. This is virtual America, we would say.

These employment and wage numbers are gruesome. Yet for proper assessment, we need a comparison with what used to be the normal pattern in past recoveries. The chart on the next page provides this measure by a comparison with the growth in wage and salary income in recoveries from 1949–1982.

Economic recoveries from recession used to be the heights of job and income creation. In past cyclical recoveries, real wage and salary incomes during their first 11 quarters have surged by 18.2% on average. Even the "jobless recovery" of the early 1990s saw 7.4% growth. In the course of the present recovery, it has been a miserable 3.9%.



THE CRUCIAL POLICY FIASCO

The appalling fact to see is that for America's working population, there never was any economic recovery over the past four years. Given generally declining real family incomes, it is in reality even worse than stagflation. What is the explanation?

It has to be realized first of all that the unprecedented monetary and fiscal stimulus applied over 2001–03 has completely failed to give traction to a broad recovery possessing the internal dynamics of job and income creation of past recoveries. For the final success of this profligate growth stimulation, it was decisive that business capital spending would in due time take over the baton from bubble-driven consumer spending. This has not occurred.

Instead, the credit excesses unleashed by these policies overwhelmingly took direction into the asset markets, particularly catapulting house prices higher. What developed was the world's greatest housing bubble, which through rising house prices forwarded almost unlimited collateral for an unprecedented consumer borrowing-and-spending binge. Homeowners, banks and other lenders seized the opportunity with a frenzy.

Apparently, it was taken for granted that the necessary job and income dynamics would spontaneously kick in in due time, allowing the U.S. economy to decouple from the housing bubble. Instead, a truly absurd growth pattern developed. Private households have slashed their saving from current income. Businesses, on the other hand, are spending less than their cash flow on organic capital investment. Mergers, acquisitions and stock buybacks enjoy overwhelming preference in corporate policy decisions.

Preposterously, business is the one and only sector in the economy with a savings surplus, while consumers and the government deliver massive deficit spending, boosting the economy's growth solely from the demand side. This is the worst possible pattern of economic growth, putting macroeconomic reason completely on its head.

Manifestly, American policymakers and most economists have yet to realize this macroeconomic folly. It is beyond their comprehension that this extremely lopsided pattern of growth is increasingly deranging the economy's long-established demand and output structure with negative effects on long-term economic growth.

A consumer starved of income growth depends, after all, on continuous asset inflation and ever-higher borrowing to maintain his living standard. The obvious main cause of this income weakness is the drastic erosion of the manufacturing sector through the perpetual trade deficit and outsourcing, both depressing domestic business fixed investment.

CREATIVE STATISTICS

We have explored the U.S. economy's performance from the perspective of employment and labor income. What we found is a far cry from a recovery deserving this designation, as determined by past experience. For the public, the dismal reality is protracted stagflation.

However, according to the GDP and productivity numbers, the American public is doing fine, far better than people in most other industrialized countries. In our view, the two have become virtually worthless indicators of economic activity and economic well being. Through numerous redefinitions and methodological changes, both the Bureau of Economic Analysis and the BLS have systematically produced better-looking figures for employment, unemployment, inflation, productivity and real GDP.

Whether the decision to change from "fixed-weighted" to "chain-weighted" inflation measures, to capitalize, rather than to expense, computer software purchases; to drastically extend "hedonic pricing" for quality

adjustments; to introduce the net birth/death model for job creation; to switch in the measuring of housing costs from house prices to "rental equivalence"; to strip the unemployment numbers by inventing "discouraged workers"; etc. — all these different statistical refinements had one common effect: They gave the U.S. economy's weak recovery an immensely better look.

The other day, *The Wall Street Journal* carried a practical example of hedonic pricing and its effect on the inflation rate. Hedonic literally means the "doctrine of pleasure." Somebody had bought a 27-inch television at $329.99. The price had not changed from month to month: *"But not to Tim LaFleur. He is a commodity specialist for televisions at the Bureau of Labor Statistics, the government agency that assembles the consumer price index… He decided the newer set had important improvements, including a better screen. After running the changes through a complex government computer model, he determined that the improvement in the screen was valued at more than $135."* Applying the principles of hedonics, *"He concluded the price of the TV had actually fallen 29%."*

The declared purpose of "hedonic pricing" is to adjust the prices of durable goods for the "pleasure" the consumer derives from quality improvements. A price increase by 10% for a washing machine compared to last year does not appear in the consumer price statistics, because the buyer got some hedonic thrills in exchange, as determined and measured by the BLS.

It should be clear that this chosen new objective of measuring price changes in the United States differs radically from the established objective of inflation statistics, which in the rest of the world was and still is the way to measure changes in consumer purchasing power. If a washing machine costs 10% more, this represents, with or without quality improvements, a corresponding loss of purchasing power for the buyer that is no longer available for other purchases. That alone is the essence of inflation.

This new idea to make "consumer satisfaction" rather than "consumer purchasing power" the litmus test of inflation statistics represents a radical change in the BLS' objective, of which very few people are aware. The practices applied altogether have reduced the U.S. inflation rate by at least 2%, if not 3%.

Another very onerous point is that the inflation rate plays a crucial role as a guideline in the economy and the financial markets, particularly for wage policy and bond yields. Besides, it serves as the measure for inflation-adjusted GDP and productivity growth. For us, this is flagrant statistical deception for particular purposes, implying a serious distortion of important prices.

MR. GREENSPAN SURPRISES

Strikingly, the whole discussion about the U.S. economy presently revolves around the one question of how quickly or slowly the housing bubble will run off. Yet the most important thing to realize is that no alternative is in sight. For further reasonable growth, a very strong contribution from business fixed investment would be needed.

All of a sudden, in his recent speeches in Jackson Hole and elsewhere, Mr. Greenspan has sounded alarm about the housing bubble. Considering his decisive role in first creating it, it is "*like Emperor Caligula warning about debauchery*," wrote Bill King sarcastically. *"As Easy Al heads for the exit, he warns of the excesses he fostered, abetted and orchestrated."*

Mr. Greenspan said, *"According to estimates prepared by the Federal Reserve Board staff, a significant portion of this sharp decline in the 10-year forward one-year rate over the past year appears to have resulted from a fall in term premiums… History cautions that long periods of relative stability often engender unrealistic expectations of its permanence and, at times, may lead to financial excess and economic stress."*

And in Jackson Hole: *"The lowered risk premiums — the apparent consequence of a long period of economic stability — coupled with greater productivity growth have propelled asset prices higher...*

"Thus, this vast increase in the market value of asset claims is in part the indirect result of investors

accepting lower compensation for risk. Such an increase in market value is too often viewed by market participants as structural and permanent. To some extent, those higher market values may be reflecting the increased flexibility and resilience of our economy. But what they perceive as newly abundant liquidity can readily disappear. ***Any onset of investor caution elevates risk premiums and, as a consequence lowers asset values and promotes the liquidation of the debt that supported higher asset prices. This is the reason that history has not dealt kindly with the aftermath of protracted periods of low risk premiums."***

Many people wonder why Mr. Greenspan is all of a sudden expressing these warnings, after hailing rising asset prices for years as a great positive for the economy through wealth creation. Why this change of mind? For us, it has an obvious reason and purpose: Sensing the inevitable end of the housing bubble, he wants to put the blame on the investors for ignoring the inherent risks, indirectly absolving the Fed from mistakes.

Mr. Paul McCulley of PIMCO revealed in his September 2005 letter what notorious bond bulls are thinking. He quoted recent remarks by San Francisco Federal Reserve Bank President Janet Yellen: *"The higher the Fed takes the fed funds rate, the greater is the probability and the nearer the timing of a hard landing for property prices and the economy and, therefore, the greater the probability and the nearer the timing of a reversal to easing. Thus, the more the Fed tightens, the lower will be the 'term premium,' which Mr. Greenspan says is the dominant cause (a 'significant portion') of his conundrum."*

The obvious bet is that the more the Fed errs in hiking rates, the sharper the following easing, and the greater the gain for the bond bulls. We think the stability of the whole grossly overleveraged U.S. financial system is at stake. The Greenspan put, definitely, did not work on the stock market in 2001–02.

The Fed, apparently, wants to unwind the housing bubble in a gradual, orderly way with "measured" increases of long-term rates. For that, it is much too late.

LOOSE CREDIT, TIGHT MONEY

It could never be in doubt that this income-short, debt-driven recovery in the United States was an unsustainable economic anomaly without staying power. It has lasted longer than we ever thought possible, but for the same reason, it has gone to far greater excess, thus promising greater trouble and pain later.

Much has been written about the spectacular imbalances that this anomalous recovery has inflicted on the U.S. economy, like the extinction of saving, the ever-widening current account deficits and the mounting debt burdens. This time, we want to address another huge imbalance finding nil attention. Credit growth and money growth have monstrously decoupled. Credit growth is exploding, while money growth is drastically lagging. See the box for the money figures.

In absolute amounts, over the 12 months to July 2005, M1 rose by $16.2 billion, M2 by $237.7 billion and M3 by $497.6 billion. This compares with credit growth of $2,017.1 billion in the nonfinancial sector and $957.5 billion in the financial sector. If you understand the credit figures as a measure of debt growth and the money figures as a measure of liquidity growth, this appears a most disturbing discrepancy between the two aggregates.

MONEY STOCK MEASURES

% change at seasonally adjusted annual rate	M1	M2	M3
2003	-1.1	2.6	7.0
2004	-0.8	2.4	6.1
2005	1.6	3.7	5.4

Source: Federal Reserve

The unusually weak money growth has been attracting some attention lately. The common conclusion of observers is that monetary policy is really very tight. It is another gross misinterpretation.

People can increase spending either by reducing their money balances received from earned income or by borrowing. Manifestly, the latter has vastly outpaced spending from income in the United States. Credit has been and remains loose as never before in history, implicitly reflecting unprecedented monetary looseness. Other than growing illiquidity, what else can you expect under these circumstances?

Let us take a closer look. Normally, money growth shadows credit growth. Whenever a bank gives somebody credit, it entitles him to pay a corresponding amount to others. To the extent that he spends, the bank charges his credit account. On the other hand, his spending against the credit account brings to its recipients an equal amount of deposits into being.

Since under conditions of loose monetary policy virtually all banks participate in the accelerating credit expansion, they effectively create each other's deposits. In this way, credit expansion and money expansion are directly correlated for the banking system as a whole. This is the famous cumulative process of money creation through credit creation.

What is now causing this unusual, tremendous divergence between the two aggregates? Thinking it over, it struck us first of all as simply axiomatic that permanent spending in excess of current income must essentially create illiquidity over time. But how and where does the liquidity — in other words, the money supply — disappear?

As the last letter hinted at, we see two specific macroeconomic causes behind the protracted weakness in money growth in the United States. One is the huge, highly visible U.S. current account deficit, and the other is rapidly escalating Ponzi finance from unpaid compound interest.

CAPITAL ACCOUNT VERSUS CURRENT ACCOUNT

First, to the trade deficit. It seems that American policymakers and most economists have yet to realize that the monstrous deficit acts as a huge sucker on the U.S. economy's money supply and income flow.

Spending on goods produced in the United States generates revenue and bank deposits for domestic retailers and producers who, in turn, will spend it again on wages and sundry other expenses. It is, in essence, a circular flow. But to the extent of the U.S. trade deficit, the money spent exits this circular flow via U.S. retailers to foreign producers instead.

To wit, an annual U.S. current account deficit of presently around $800 billion implies an equivalent net loss of current income and bank deposits for the U.S. economy. Both flow, instead, to the foreign producers. The predominant loser is the U.S. economy's manufacturing sector, because foreign trade is always trade in manufactured goods.

But does this money not promptly return to the United States buying U.S. assets? Yes, but the crucial point to see is that it is not returning into the economy's income and spending stream, from where it has left. Instead, it flows into the U.S. financial markets, adding to their liquidity and boosting asset prices. Nothing is added to the income and spending process in the U.S. economy.

There are principally two different kinds of spending for which money is utilized. One kind is goods and services from current output, adding up to the gross domestic product. The second kind is spending on existing property, land, buildings, plant and equipment and all sorts of paper assets, such as stocks, bonds, mortgages, etc., representing national wealth. Sales and purchases in this category of values take place entirely outside GDP.

As a result, at any given time, some part of the total money supply is employed in transactions impacting GDP growth and another part is at play in selling and purchasing existing assets, driving their prices upward or downward, leaving GDP untouched.

Keynes explicitly classified the two components of the money supply as "industrial circulation" versus "financial circulation." Keynes explains: *"By industry, we mean the business of maintaining the normal process of current output from the first beginning of production to the final satisfaction of the consumer."* Other economists distinguished between *"income circulation" and "capital circulation."*

The important thing to see about an annual $800 billion U.S. trade deficit is that it shifts an equal amount of money supply from "industrial" circulation to "financial" circulation — respectively, from "income" circulation to "capital" circulation. There is correspondingly less money for production and consumption and correspondingly more money for asset purchases.

The money's return to the U.S. economy through the capital account is, of course, to the liking of Wall Street playing the asset markets; however, the full amount has been extracted from the domestic income and spending circulation.

Intrinsically, a trade deficit implies a corresponding subtraction from the following four aggregates: money stock, income, spending and GDP. Maintaining domestic growth notwithstanding, it needs loose monetary policy to substitute for these inroads through additional credit creation.

THE PONZI TRAP OF UNPAID INTEREST

Now to the Ponzi component behind this growing imbalance between credit growth and money growth. The expression "Ponzi finance" — derived from some fraud in 1919–20 — simply means that lenders capitalize unpaid interests, rather than adding them to their bad loan reserves. As this credit creation involves no new spending on the part of the borrowers, it also involves no money creation.

There is, in short, no cash flow. But as the increasing collateral from the housing bubble appears to create rising wealth and collateral on the part of the illiquid borrowers, nobody cares. The pleasant counterpart to this credit creation for the lenders is profit creation. With this reasoning, the banks are setting aside lesser and lesser reserves against possible losses.

There is, in short, no cash flow. But as the increasing collateral from the housing bubble appears to create rising wealth on the part of the illiquid borrowers, they do not care. For the lending institutions, the pleasant counterpart to this credit creation is corresponding profit creation. With the same reasoning, the banks are setting aside lesser and lesser reserves against possible losses.

Pondering the economic and financial implications of rampant Ponzi finance in the United States, we took another close look at the writings of Hyman P. Minsky, particularly his 1986 book *Stabilizing an Unstable Economy*. His famous thesis is that in the capitalist economy, prolonged phases of stability inexorably lead to financial excesses, implying falling margins of safety.

In his analysis, he identifies three distinct income-debt relations for economic units: hedge, speculative and Ponzi finance:

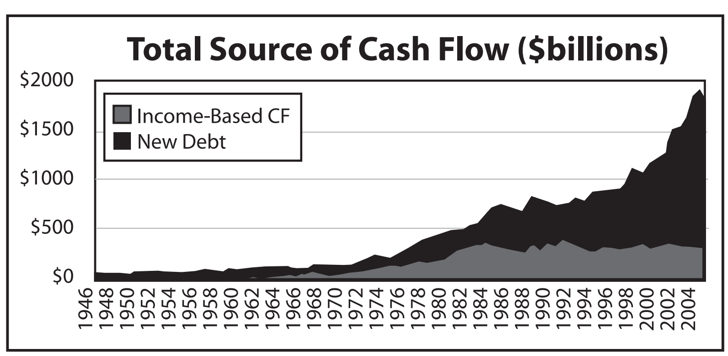
(1) Hedge-financing units can fulfill all of their contractual payment obligations by their cash flow.

(2) Speculative units can meet the interest bill on their liabilities from their income but are unable to repay the principal out of cash flow from operations. They need to roll over their liabilities.

(3) Ponzi units are unable to fulfill repayment of principal and to pay the interest due on outstanding debts by their cash flow from operations. They depend on borrowing or selling assets even to meet their interest bill.

It is a reasonable conclusion that the U.S. economy and its financial system on the whole have become one huge Ponzi Financing unit. We draw this conclusion from a simple comparison of the existing total indebtedness and inherent interest expenses to the national income, from which the debt service has to be paid.

Total U.S. debts, nonfinancial and financial, amounted to $37.3 trillion in the first quarter of 2005, up 112% over the last 10 years. Assuming an average interest rate of 5%, total annual interest expenses come to almost $1.9 trillion. This compares with an increase in national income by about $814 billion. Consumer debts are up 121%, to $10.7 trillion, over the same period, comparing in general with stagnation or falling real disposable income. The chart to the right provides a most frightening picture of the dramatic deterioration in the relationship between poor household income growth and exponential debt growth.



In our view, Ponzi financing in the United States has passed the point where an orderly solution for the debt orgy is still possible.

A DISMAL PROFIT OUTLOOK

As we have repeatedly emphasized, the U.S. economy's key policy failure is badly lagging business fixed investment. This also has dismal consequences for profits.

Our very negative view about its prospects in the United States has major macroeconomic reasons. Assessing the most important profit outlook, we distinguish between macro influences, over which the individual firm has no control, and micro influences, which it can determine.

It is a common mistake to treat consumer spending as the most important source of business profits, because it represents the largest component in GDP. This view overlooks that wages and salaries are a big business expense in the first place. Since some part of this income is normally saved, business revenues from consumer spending generally fall short of their wage and salary expenses, implying an overall loss. Only credit-financed consumer spending adds to profits on the macro level. Implicitly, the unprecedented consumer borrowing-and-spending binge of the last several years has been a main source of higher U.S. business profits.

For the business sector as a whole to make a profit, it needs revenues from expenditures involving no expenses. These profit-creating revenues may come from four major sources: credit-financed consumer spending, business investment in plant and equipment, business inventories and net exports.

When a firm purchases plant and equipment, it pays with earned or borrowed cash. No expense is incurred until the first depreciation charge sets in. But for the producers of the capital goods, the transaction is a sale that produces immediate revenue. In this way, net business fixed investment — gross investment minus depreciations — is typically the most important macro source of business profits. In the United States, though, this component is dead in the water.

By far the worst macro influence on U.S. business profits, on the other hand, is the monstrous trade deficit, which simply diverts an equal amount of business revenues from domestic to foreign producers.

WHAT IS WRONG WITH THE GERMAN ECONOMY?

German voters managed to create the worst possible election result. Much has been written about horrible economic consequences. We have no doubt that German businesses will continue to plow ahead with restructuring measures, also involving job cuts, rather than wait for the government to enact further changes in the employment laws.

Actually, Gerhard Schroeder's government had initiated significant reforms hurting people. That is why he got the boot. On the other hand, Angela Merkel failed to convince, for good reasons. Her ideas of a flat tax rate of 25% and a hike in the sales tax by 2% were equally foolish, politically and economically.

Trying to assess an economy, we expect very little or nothing positive from governments. The chief actors are consumers and businesses. In the first place, we focus on the crucially important macroeconomic growth fundamentals: available savings, investment, the trade balance and debt growth. From this perspective, we know that the German economy is on an incomparably better footing than the U.S. or the British economy.

Greenspan and Wall Street folklore have it that the Anglo-Saxon economies, and the U.S. economy in particular, are persistently outperforming the European economies, owing to vastly superior flexibility, especially in hiring and firing labor.

The all-too-manifest key propellant of U.S. economic growth during the past several years has been the consumer borrowing-and-spending binge, powered by the housing and mortgage refinancing bubble, as strikingly reflected in the collapse of saving.

We emphasize this point because the difference in economic growth between the United States and

Germany has its manifest main cause in dramatically different savings behavior. The German public saves close to 11% of its disposable income. If the Anglo-Saxon countries had savings ratios like those of Germany or France, their economies would be in deep depression, not just recession. Germany's other major depressant is a protracted slump in building — down more than 30% since 1996 — from its bubble level in the wake of reunification.

In the times of the gold standard, the key measure of an economy's performance was the balance of payments, more precisely net exports, reflecting international competitiveness. Faced with sluggish domestic demand, German manufacturers have displayed tremendous flexibility in boosting exports.

Since 2000, total exports are up about 30%. Germany's current account balance has since then swung from a deficit of €32.7 billion into an annualized surplus of more than €100 billion during the first half of 2005. It seems to us that this reflects a degree of flexibility that has no equal in the world, considering, moreover, that this happened against a steep rise of the euro against the dollar. At the same time, the U.S. current account deficit surged from $415 billion to almost $800 billion.

Germany's economy is definitely in excellent shape on its supply side. All this talk about lacking flexibility is malicious and stupid. The major economy in the world that needs the most extensive restructuring is the U.S. economy, with zero national savings and its monstrous trade deficit.

CONCLUSIONS:

U.S. economic growth depends on a single prop: the epidemic borrowing against the housing bubble. But its cooling has begun. Very serious repercussions on the economy have to be expected within a few months. The two hurricanes are not the cause, but they may act as the catalyst.

The key point to see about the U.S. economy is that the lavish fiscal and monetary stimulus of the past several years has completely failed to generate sufficient traction for a broad, self-sustaining expansion. These policies have had three correlated, decisive failures: chronic weakness in business fixed investment; structural recession in manufacturing; and a virtual breakdown of the famous job machine with fatal repercussions on income creation.

The two all-important points to realize are that the U.S. economy and its financial system are today in far worse shape than in 2000–01; and that in the arsenal of monetary and fiscal policy, there is little or nothing left. All U.S. asset markets are ridiculously overvalued through carry trade.

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